BEFORE THE NEBRASKA PUBLIC SERVICE COMMISSION

In the Matter of Aquila, Inc. d/b/a Aquila Networks (Aquila), Omaha, seeking individual rate increases for Aquila's Rate Area One, Rate Area Two, and Rate Area Three.	))))))	Application No. NG-0041 ORDER GRANTING APPLICATION IN PART Entered: July 24, 2007

BY THE COMMISSION:

On November 15, 2006, Aquila, Inc., d/b/a Aquila Networks (Aquila) filed an application seeking individual general rate increases for Aquila's Rate Area One, Rate Area Two, and Rate Area Three. Interventions were filed by Cornerstone Energy, Inc. (Cornerstone); Kinder Morgan, Inc., now known as SourceGas Distribution (SourceGas); and the Public Advocate.

In summary, Aquila sought a total revenue increase of $16.3 million and an overall rate of return of 9.6 percent. Aquila requested an increase in the residential customer charge from $11.00 to $16.00 per month. Furthermore, Aquila proposed a single residential volumetric charge of $0.14868 per therm for all three rate areas.[1] With respect to business ratepayers, Aquila sought an increase in the customer charge from $15.00 to $20.00 as well as a single business volumetric charge of $0.15803 for all three rate areas.[2]

In addition to the changes in the customer and volumetric charges, Aquila proposed an Energy Efficiency Rider to provide funding for Aquila's two proposed energy efficiency programs 1) space and water heating equipment rebates; and 2) Low-Income Weatherization. Aquila further proposed a Revenue Normalization Adjustment (RNA), a monthly adjustment accounting for variations in revenues received by the company; a Weather Normalization Adjustment (WNA), an automatic adjustment for variations in revenues attributable to weather; and a Limited Cost Recovery adjustment (LCR), which would provide automatic rate increases to the utility based upon inflation without the necessity of a rate application.

Hearing on this matter was held on May 30 and 31, 2007. Steve Pella; Richard Petersen; Ruth Gustin; Philip Beyer; Glenn

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[1] The current residential volumetric charges for each rate area are as follows: Rate Area One (Near Omaha) = $0.10967 per therm; Rate Area Two (Lincoln) = $0.11070 per therm; and Rate Area Three (Rural Eastern Nebraska) = $0.12177 per therm.

[2] The current business volumetric charges for each rate area are as follows: Rate Area One (Near Omaha) = $0.12700 per therm; Rate Area Two (Lincoln) = $0.15922 per therm; and Rate Area Three (Rural Eastern Nebraska) = $0.15266 per therm.

Dee; Vern Siemek; and Paul Raab testified on behalf of Aquila. Kimberley Lillyblad; Albert Bartsch; and William Glahn testified on behalf of the Public Advocate. Additionally, several documents were entered into the record including copies of written testimony filed on behalf of Aquila, the Public Advocate, and Cornerstone Energy; all responses to data requests; summaries of customer contacts; and various work papers.

OPINION AND FINDINGS

"Every rate made, demanded, or received by any natural gas public utility shall be just and reasonable. Rates shall not be unreasonably preferential or discriminatory and shall be reasonably consistent in application to a class of ratepayers."[3]

"The commission, in the exercise of its power and duty to determine just and reasonable rates for natural gas public utilities, shall give due consideration to the public need for adequate, efficient, and reasonable natural gas service and to the need of the jurisdictional utility for revenue sufficient to enable it to meet the cost of furnishing the service, including adequate provisions for depreciation of its utility property used and useful in rendering service to the public, and to earn a fair and reasonable return upon the investment in such property."[4]

"Cost of service shall include operating expenses and a fair and reasonable return on rate base, less appropriate credits."[5]

With the exception of the items specifically addressed herein, the Commission grants Aquila's application subject to the adjustments and limitations discussed below.

RATE BASE

"The rate base of the jurisdictional utility shall consist of the utility's property, used and useful in providing utility service, including the applicable investment in utility plant, less accumulated depreciation and amortization, allowance for working capital, such other items as may be reasonably included, and reasonable allocations of common property, less such investment as may be reasonably attributed to other than

[3] *Neb. Rev. Stat.* § 66-1825(1) (2003).
[4] § 66-1825(3).
[5] § 66-1825(4).

investor-supplied capital unless such deduction is otherwise prohibited by law."[6]

"The rate base shall ordinarily consist of those items which are used and useful in providing service to the public."[7] In calculation of rate base, Aquila has sought several adjustments.

"Post test year adjustments are permitted for known and measurable rate base adjustments to test year where the utility accounts for any related impacts on all aspects of the jurisdictional utility's operations. Related impacts are those that reasonably follow as a consequence of the post test year adjustment being proposed, including a related impact of another post test year adjustment."[8]

Capital Additions

Aquila seeks a capital addition adjustment, which increases plant in service by $12,776,870.00 relating to construction work in progress.

Pursuant to *Neb. Rev. Stat.* § 66-1817,

> (1) Any jurisdictional utility property may be deemed to be completed and dedicated to commercial service if construction of the property will be commenced and completed ***in one year or less.***
>
> (2) The commission may determine that property of a jurisdictional utility which has not been completed and dedicated to commercial service may be deemed to be ***used and useful*** in the utility's service to the public.

Rate base "may include items completed and dedicated to commercial service for which construction will be commenced and completed within one year or less from the end of the test year."[9]

Aquila did not provide direct testimony specifically addressing the capital additions adjustment. However, work papers ADJ-1 to ADJ-18 were provided in the original filing and as Exhibit VJS-1 in rebuttal testimony. The work papers include

[6] § 66-1825(6).
[7] Neb. Admin. Code, Title 291, Ch. 9 § 005.06D (2006).
[8] § 005.06F.
[9] § 005.06D.

a brief description of the project, the FERC account affected by the project, costs for 6 months in 2006 and 6 months of 2007 by rate area. Additionally, it includes a listing of the depreciation rate and depreciation expense. It also contains spreadsheets purporting to offer capital variance explanations and budgets for the various capital projects included in the adjustment.

Mr. Siemek further states in his rebuttal testimony that information regarding capital additions was provided in Responses to PA DR 20 and 69, which were included in Exhibits VJS-2 and VJS-3.

Aquila contends that the adjustment "reflects the impacts of Capital Additions to be made by June 30, 2007" and that the additions "impact plant in service, depreciation expense, and accumulated reserves for depreciation."[10] According to Aquila, "The capital Additions Adjustment included only integrity projects since growth projects would have revenues to offset the investment."[11]

The Public Advocate contends that the adjustment should be disallowed as Aquila failed to provide sufficient explanation in the record regarding the adjustment in order for the Commission to determine whether the additions are used and useful or whether the costs are known and measurable and prudently incurred.[12] On behalf of the Public Advocate, Mr. Glahn testifies, "Without a witness to depose, to direct data request to, or to cross-examine under oath, inclusion of this Adjustment in the rate base, and, thus, in rates, raises obvious due process problems."[13]

The Commission is compelled to respond specifically to Mr. Glahn's contention that due process issues exist with respect to Aquila's presentation of evidence on this issue. The Commission finds that in light of the fact that specific data requests were made regarding this adjustment, and the witness who provided rebuttal testimony on this adjustment was available during the hearing, we find that no due process issues exist. However, in future rate cases, the Commission would expect utilities to provide direct testimony specifically addressing the substantive evidence on the adjustment.

[10] Rebuttal Testimony of Vern Siemek, 2:20-22.
[11] Siemek Rebuttal, 2:27-28.
[12] Testimony of William Glahn, 31:21-32:2.
[13] Glahn, 32:2-5.

Pursuant to § 66-1817, it is entirely within the Commission's discretion as to whether construction work in progress will be included in rate base. In this case, although some evidence was presented regarding the capital additions in progress, very little explanation was offered regarding the nature or status of the various capital addition projects. Furthermore, no specific explanations were given as to the reasons for or necessity of the projects. In light of the fact that this is a discretionary post test year adjustment, the Commission finds that Aquila did not provide sufficient explanation regarding this adjustment in order for the Commission to determine that the capital additions will be ***used and useful*** in the utility's service to the public and should be included in rate base immediately.

In future filings, the Commission would expect that direct testimony include a discussion of each project; why the utility has determined that the project is necessary to the provision of safe and reliable gas service; and how the project costs are being financed, whether through debt or internally generated cash. Additionally, the utility should describe why it is necessary for the project to be included in rates before it is complete and in service.

Evidence presented should include a list of all construction projects the utility is requesting to include in plant in service which should include a description of the project; location of the project; purpose for the project; date construction was begun; expected completion date; actual costs incurred as of the last day of the test year; and finally total expected cost for the project at completion.

Offutt Housing

Aquila seeks an adjustment, related to the privatization of Offutt Air Force Base housing, which increases plant in service by $1,094,690.00, reduces test year revenues by $362,965.00, reduces the cost of sales by $290,372.00, increases operating expenses by $93,663.00 and reduces sales volumes by 50,957.[14] The project will include "demolition, abandonment, renovation and rebuilding to yield 1,631 modernized units by 2011."[15] Aquila asserts that the adjustment is necessary "to properly reflect and match margins, costs and investments included in the test period to the margins, costs and investments after the project is completed."[16]

[14] Direct Testimony of Vern Siemek, 20:19 - 23:14.
[15] Siemek, 21:3-5.
[16] Siemek, 21:18-21.

The Public Advocate presented evidence that this constitutes a "selective adjustment"[17] as Aquila "has not seen fit to include any expansion projects, currently under construction that would increase revenues."[18] The Public Advocate recommends that this adjustment be denied.[19]

The expected completion date of this project is well beyond the test year, rendering this adjustment speculative and therefore not "known and measurable". However, the Commission has the discretion to allow Aquila to include in its rate base "property which has not been completed and dedicated to commercial service".[20] The Commission attempted, based upon the information in the record, to determine whether there was a portion of the adjustment that could be allowed because the investment was already made. However, no such determination could be made with the information available. Therefore, the Commission finds that it would be inappropriate to include estimates for costs associated with a construction project scheduled to be completed a full five (5) years after the test year and this adjustment is disallowed.

Gas In Storage

Aquila seeks an adjustment to rate base of $18,157,457 based on the estimated volumes and price of gas planned to be in storage at December 31, 2006, six months after the end of the test year.

The Public Advocate agrees that a Gas Storage adjustment is appropriate but recommends that the amount of the adjustment be based upon average monthly gas in storage inventory amounts for the twelve-month period corresponding to the test year.[21] Mr. Bartsch testified that "The use of the projected inventory in any one month, when the gas in storage varies significantly throughout the test year, will result in a totally inappropriate adjustment either in a positive or in a negative direction."[22] Mr. Bartsch proposes an adjustment of $11,184,632.[23]

As with other post test year adjustments to the rate base, Aquila must show that this asset is "used and useful" in the provision of natural gas service and that the amount of the

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[17] Direct Testimony of Albert Bartsch, 5:20.
[18] Bartsch, 5:16-17.
[19] Bartsch, 5:12.
[20] § 005.06D
[21] Bartsch, 6:8-11.
[22] Bartsch, 6:4-7.
[23] Bartsch, 6:13-14.

adjustment is "known and measurable". Aquila has proposed valuing gas in storage based upon a single point in time which does not provide an accurate representative valuation of the asset. Mr. Dee acknowledged that the balance of gas in storage varies throughout the year with the highest storage levels occurring from October through December and the lowest levels occurring from April to May.[24] The Commission finds that an adjustment for gas in storage is appropriate as it is "used and useful" in the provision of natural gas service. However, we further find the Public Advocate's recommendation that a twelve-month average of historic data over the test-year period is a more appropriate method for determining a "known and measurable" adjustment in this context.

Cash Working Capital

An additional component of rate base is an allowance for working capital.[25] The allowance for working capital includes "[a] prudent allowance for cash working capital."[26]

Cash working capital is a component of invested capital or rate base. Aquila proposes to include a $3,344,444 cash working capital allowance in rate base, which Aquila calculated based on a lead/lag study. On Exhibit VII, Schedule A, page 1 of its filing, Aquila explains that "Lead/lag measures the amount of cash working capital needed by looking at the timing difference between when cash comes in and when it is disbursed for various expenses." While a lead/lag study is the best method for measuring cash working capital, there are many opportunities to impact the outcome.

Mr. Glahn explains "Ratepayers pay a return to investors on working capital to the extent the capital is supplied by investors."[27] He points out at page 41 of his direct testimony that Aquila failed to include two sources of non-investor supplied cash in its lead/lag study: city franchise fees and sales tax. Relying on Aquila's responses to Public Advocate Data Requests PA-87 and PA-112, Mr. Glahn calculated the lag for franchise fees and concluded that including this lag in the lead/lag study reduces cash working capital by $1,609,722.[28] Relying on Aquila's responses to Public Advocate Data Requests PA-113 and PA-114, Mr. Glahn calculated the lag for sales tax to be 40 days, which reduces Aquila's cash work capital allowance by $271,632. Mr. Glahn recommends that Aquila's cash working

[24] See Transcript, 112:3-18.
[25] § 005.06B.
[26] § 005.06B3.
[27] Glahn, 40.
[28] Exhibit WLG-15, p. 4 of 5.

capital allowance be reduced by these amounts, which total $1,881,354.

Mr. Dee argues, in his rebuttal testimony, that "neither franchise fees nor the sales tax collected are sources of working capital" according to Mr. Glahn's definition. While Mr. Dee does not specifically reference the definition to which he refers, Mr. Glahn states at page 40 at lines 7 and 8: "The amount of working capital a company needs depends upon its revenue stream and expenses." Mr. Dee claims at pages 5 and 6 of his rebuttal testimony that "franchise fees are not inventories, prepayments, revenues, or expenses" and, therefore, should not be included in the lead/lag study. He makes the same argument with respect to sales tax.

Mr. Dee argues in his rebuttal that Mr. Glahn erred in his calculation of the lead days for both franchise fees and sales tax. Mr. Glahn's calculation of the lead on sales tax assumes that Aquila remits sales tax to the state after it is collected from Aquila's customers. Mr. Dee stated during cross examination that sales tax is owed to the state after it is billed. Mr. Dee recalculated the impact on cash working capital for both sales tax and franchise fees in his rebuttal testimony. His calculations indicate that franchise fees provide a source of cash working capital of $277,333, while sales tax creates a need for working capital of $266,417. The net difference is a source of cash working capital of $10,916.

The Commission agrees with Mr. Dee's calculations of the impacts of these two items on Aquila's cash working capital needs. Because the impact demonstrated by Mr. Dee is *de minimis*, the Commission concludes that Aquila's requested cash working capital of $3,344,444 is reasonable.

OPERATING EXPENSES

"Operating expenses shall consist of expenses ***prudently incurred to provide natural gas service*** including (a) a reasonable allocation of common expenses as authorized and limited by section 66-1819 and (b) the quantity and type of purchased services regulated by the Federal Energy Regulatory Commission."[29]

[29] § 66-1825(7)(emphasis added).

Contributions, Donations and Dues

If a jurisdictional utility seeking a general rate increase wishes to include in its operating expenses any "funds expended in support of or membership in social, recreational, fraternal, or religious clubs or organizations" each must be separately identified in its financial summary.[30] Aquila seeks to include fifty percent of such expenses. The Commission will first address contributions and donations, followed by membership dues and fees.

With respect to contributions to community associations and organizations, Mr. Pella testified "Aquila is rightfully expected to make contributions to community associations and organizations . . . Such expenditures are necessary for Aquila to maintain its standing and goodwill in the local communities; do provide benefit to the community's effort to grow; and are a customary and legitimate cost of doing business."[31]

Mr. Pella testified that the fifty percent figure was used in order to avoid having to do an item by item review of each expense as the amounts in question were relatively small.[32] Specifically, Mr. Pella stated, "We realized some contributions in the list could be debated more than others, which really led to the 50 percent rule to avoid sort of a line-by-line debate of value."[33]

The Commission recognizes that contributions to charitable or educational institutions benefit the utility by fostering goodwill in the community and benefit the communities in which a utility provides service. However, allowing inclusion in rate base of contributions to charitable and educational institutions would be to require ratepayers to become involuntary contributors to charities, causes or institutions which they may not support. The appropriate standard for the inclusion of expenses is whether said expenses are "prudently incurred to provide natural gas service."[34] The Commission finds contributions to charitable or educational institutions should not be included as operational expenses as they do not relate to the provision of natural gas service.

Aquila has divided the membership fees and dues sought into five (5) categories: associations, trade, organizations,

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[30] § 004.01B(4).
[31] Rebuttal Testimony of Steve Pella, 3:1-6.
[32] Pella Rebuttal, 3:13-18.
[33] Tr., 30:4-7.
[34] § 66-1825(7).

fraternal, and country.[35] In support of the amounts sought for "organizations", Mr. Pella testified "that it is important to be involved in local chambers of commerce because those organizations seek to grow the communities Aquila serves. This economic development and civic activity increase Aquila's customer base and load profile."[36]

The Commission finds that the requested percentage of membership dues and fees which directly contribute to the growth and retention of Aquila's customer base and specifically relate to the business of providing natural gas service in Nebraska should be permitted. Those expenses which do not directly contribute to the growth and retention of Aquila's customer base are more similar to contributions to charitable and educational institutions which foster goodwill and benefit the communities but do not directly impact the provision of natural gas service. Expenses that pertain to the operation of a natural gas utility, such as involvement in appropriate trade groups, should be included as requested.

As a matter of public policy, the Commission specifically finds that no expenses related to lobbying or legislative advocacy activity will be allowed. It is our understanding that any amounts attributable to lobbying and legislative advocacy activity have been excluded as part of the fifty percent factor adopted by Aquila.

As no evidence was offered specifically addressing each organization individually, the determination regarding inclusion of a particular expense must be based upon the limited information available in the record. In those cases in which the purpose of the entity or the nature of the fee or dues is unclear, it should be excluded. Furthermore, any fees or dues attributable to an organization outside of Nebraska should be excluded as should country club dues. Additionally, all expenses listed as "sponsor" should also be excluded as no evidence was offered as to the nature of the sponsorship. Finally, all contributions to charitable and educational organizations must be excluded as explained previously.

Annualized Depreciation Reserves

Aquila proposed an adjustment of $3,031,242 to its depreciation expense and reserves "to reflect the annualization of expenses based on June 30, 2006 plant balances ... . The adjustment also includes updated depreciation rates resulting

[35] Pella Rebuttal, 5:16-18.
[36] Pella Rebuttal, 6:17.

from a study performed by outside consultants Foster and Associates, and an adjustment for common assets that serve all utilities in the Aquila network."[37]

The Public Advocate asserts that this adjustment should be disallowed on the basis that "This adjustment to reserves represents depreciation expense that should have been charged to ratepayers for many years. Those ratepayers were undercharged, but to go forward and collect this cost from current and future ratepayers would mismatch costs and benefits and would be a classic example of unrepresentative costs."[38] In the alternative, the Public Advocate recommends that a lower adjustment be made in the amount of $2,175,184.[39]

In rebuttal testimony, Aquila witness Ronald White testified that the adjustment proposed by Mr. Glahn was based on the difference between the whole life rates and the remaining life rates.[40] Mr. White further testified that because Aquila adopted the remaining life rates, the analysis proffered by Aquila is accurate.[41]

The Commission finds that Aquila has properly adjusted its depreciation expense based upon the remaining lives method. Therefore this adjustment as proposed by Aquila should be included in the determination of rates.

Payroll Adjustments

a. Payroll Annualization

Aquila proposes to increase annual payroll costs by approximately $1,983,305.

The payroll annualization adjustment "was made to annualize payroll expense to reflect changes in payroll costs through August 15, 2006. … The annualized base pay amount was also adjusted for known vacancies and other than base payroll categories such as standby, overtime and callout pay."[42] The adjustment includes all open positions for Nebraska operations, with the exception of any part-time or temporary positions.[43]

[37] Direct Testimony of Richard Petersen, 6:14-22.
[38] Glahn, 33:5-9.
[39] Glahn, 33:9-10.
[40] Rebuttal Testimony of Ronald White, 3:17-4:10; 5:1-6:5.
[41] White Rebuttal, 6:7-20.
[42] Petersen, 7:3-4; 7:7-9.
[43] See Petersen, 7:12-18.

The Public Advocate contends that this adjustment should be disallowed as it includes vacant positions and should have been based on payroll costs as of the end of the test year rather than August 15, 2006.

On rebuttal, Aquila recalculated the payroll increase using actual salaries as of March 2007 data and excluding vacant positions. Based upon the recalculation, the adjustment is reduced by $373,806.00. Mr. Petersen testified that "March 15th is the constant month in which annual merits are granted to all employees, and then the month in which the variable base pay component of the payroll increase is granted. So March is when all the payroll changes take place."[44]

The Commission finds that it is proper to rely upon the actual salaries as of March 2007 as there are no matching issues related to this expense as it does not vary directly with the number of ratepayers or volumes delivered.

Due to the fluid nature of personnel, some number of vacant positions will always exist whether attributable to staff turnover or restructuring. During the time that the positions remain vacant, a company does not incur any expenses related to salary or benefits for that person. Aquila testified that consultants or temporary personnel would be needed to fill the vacancies. However, if that were the case, those expenses should be included in the test year. The Commission finds that the portion of the adjustment related to vacant positions is not "known and measurable" and should be disallowed. The Commission finds that the remainder of the adjustment should be permitted using the data for actual payroll recalculated by Mr. Peterson as of March 2007.

b. Variable Compensation Plan

Aquila also seeks an adjustment related to a 150 percent increase in the employee variable compensation plan which results in an increase in operating expenses of $373,806.00.[45]

"Aquila maintains a variable compensation or incentive pay plan for non-union employees, which is based on both the achievement of individual objectives and non-financial company objectives."[46] The "non-financial" company objectives include "satisfactory customer service, service reliability, effective use of capital for projects, safety and to maintain or reduce

[44] Tr., 81:9-13.
[45] Aquila Application
[46] Petersen, 8:20-22.

Aquila's cost of service."[47] In addition, to the "non-financial" objectives, employees "also have objectives for individual projects related to their work responsibilities."[48]

Aquila did not provide any detail as to the metrics relied upon in determining whether objectives were met. Furthermore, no evidence was offered to explain the basis for the 150 percent increase in the program. Finally, no historical information was offered as to what portion of the possible incentive has been paid in the past. In rebuttal, Aquila states that the amount of variable compensation actually paid in March 2007 was $212,910.00.[49]

The Commission finds that consideration of the actual amount paid in March 2007 is proper under these circumstances in order to achieve the most accurate adjustment possible. No matching issues exist as the amounts do not relate to the number of ratepayers or volumes sold. Because the amount is based on actual amounts paid, it constitutes a "known and measurable" adjustment.

However, the Commission further finds that the nature of the objectives appear to benefit both ratepayers and shareholders and it would be improper for the ratepayers to bear the full cost of this benefit. Therefore, the Commission finds that Aquila is entitled to an adjustment of fifty percent of the actual amount paid in March 2007 or $106,455.00. Although the Commission has no desire to micromanage the internal affairs of the jurisdictional utilities, it must have sufficient information in order to determine whether expenses are prudently incurred. Therefore, in future rate filings, applicants shall file greater detail regarding these programs as well as historical data regarding success or failure of incentive programs so as to allow the Commission to determine the prudence of the expense.

c. Economy of Scale

Aquila proposed an adjustment to reflect changes in staffing that have already occurred and will continue to occur due to the sale of Aquila's assets, such as the "sale of Michigan, Minnesota, and Missouri gas properties, and the upcoming sale of Kansas electric properties."[50]

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47 Petersen, 9:7-9.
48 Petersen, 9:10-11.
49 Rebuttal Testimony of Richard Petersen, 7:4-6.
50 Petersen, 10:9.

In his direct testimony, Aquila witness Petersen explained that this adjustment reflects the "post-sale net reductions in corporate staffing as allocated to Nebraska."[51] Mr. Petersen further explains that this adjustment "represents the value of additional reductions in the number of employees known at this time and scheduled for elimination between the end of the test year of June 30, 2006 and December 31, 2006."[52] Aquila's proposed adjustment also eliminates 2005 non-incentive corporate employee bonuses that were assigned to Nebraska. The adjustment reduces base period operating expenses by $395,046, reduces taxes other than income taxes by $20,110, and reduces plant in service by $47,816.

Aquila's adjustment reflects a reduction of 27 positions. Aquila's response to Public Advocate Data Request PA-77 states "Actual support staff reductions applicable to Nebraska were a reduction of 56 positions…" Aquila also states in this response "no further reductions related to the reorganization of Aquila are expected during the first half of 2007." The Public Advocate's expert, Mr. Glahn, recommends that the Commission disallow Aquila's proposed adjustment to reduce base year expenses because it was not known and measurable as evidenced by the fact that the actual staff reduction was more than double the number of positions reflected in Aquila's adjustment.

In rebuttal testimony, Aquila's expert, Mr. Petersen, provided updated payroll information that incorporated the information provided in response to Public Advocate Data Request PA-77. Mr. Petersen "recalculated the payroll annualization with actual data available as of March 15, 2007" excluding vacant positions.[53] The March 15, 2007 data indicates that payroll and related benefits increased by $1,609,499 when compared to the base period actual costs.

The Commission would have expected the Public Advocate to incorporate the additional staff reductions indicated in the response to PA-77 into his recommendation rather than to simply state that the adjustment is not known and measurable because the amount initially proposed by Aquila was not totally accurate and to recommend that the adjustment be disallowed. According to Aquila's response to Public Advocate Data Request PA-77, this adjustment is known and measurable. Furthermore, a utility may propose adjustments based on the best information available at the time it prepares its rate filing and reasonably update the information through discovery.

[51] Petersen, 10:19.
[52] Petersen, 14:5.
[53] Petersen Rebuttal, 3:10.

The Commission's decision on this issue is discussed below.

d. Merit Increases (Non-Union)

Aquila has proposed increases in pay for both union and non-union employees. The increases for union employees are undisputed and clearly represent "known and measurable" adjustments based upon clearly defined contractual obligations. However, the pay increases for non-union employees are within the discretion of the company. In his rebuttal, Mr. Petersen proposes an updated adjustment which includes "the actual March 2007 non-union employee merit increases and the union increase".[54]

The Commission finds that the merit increase adjustment for non-union employees through March 2007 is "known and measurable" and should be included.

e. Summary of Payroll Related Issues

As previously discussed, Aquila witness Petersen provided updated payroll information in his rebuttal testimony. At page 8 of his rebuttal testimony, Mr. Petersen recommended that his updated payroll adjustment be included in rates and explained that this updated amount includes Aquila's proposed economies of scale adjustment and its proposed merit pay increases for both union and non-union employees. Mr. Petersen also recommends a $207,814 increase for vacant employee positions and a $212,910 increase for variable compensation. Mr. Petersen's recommendation in his rebuttal testimony reduces Aquila's original request for these items by $531,169.

The Commission adopts Mr. Petersen's $1,609,499 increase for payroll with the exception of the adjustments described herein. The Commission rejects Aquila's proposal to include any amount in rates for vacant positions, and includes only fifty percent of the requested adjustment for variable compensation for the reasons discussed earlier.

Benefit Adjustment

Aquila seeks an adjustment of $1,498,736.00 in employee benefits which represents an anticipated increase related to health care costs. "Aquila's medical cost increases for the five years prior to 2007 averaged under 10 percent per year, while the national average for similar preferred provider plans

[54] Petersen Rebuttal, 9:4-7.

was up to 8.2 percent higher."[55] Aquila provides general information regarding market trends and historical data regarding past claims in support of the adjustment.

The Public Advocate contends that this adjustment is not a "known and measurable" change and should therefore be rejected.

The Commission recognizes that health care costs continue to rise. However, the Commission finds that the 14.8 percent increase sought by Aquila is merely a projection and does not constitute a "known and measurable" adjustment. Therefore, the Commission finds that the health care costs adjustment should not be included.

Postage Adjustment

Aquila had requested a post test year adjustment to its postage expense to reflect an anticipated $.03 increase in the postage rate. However, after the filing, the postal service's governing board approved an increase of only $.02 effective May 14, 2007. As a result, Aquila stated in its rebuttal testimony that its original adjustment should be reduced to reflect the actual postage rate increase.[56] The Public Advocate seeks to disallow this expense arguing that it was not a "known and measurable" change at the time of Aquila's application.[57]

The postage expense is a prudent cost incurred in the provision of natural gas service. Although the increase in postal rates occurred nearly a year after the end of the test year, it is a known and measurable change, affecting the revenue requirement of the utility. The original adjustment was based on the actual postage costs incurred during the test year, restated to reflect a higher postage rate. It is possible to correct the amount based upon what is now known about the postage rate based upon the information contained within the record. The adjustment as modified by the current postage rate should be permitted.

COST OF CAPITAL

"In determining a fair and reasonable return on the rate base of a jurisdictional utility, a rate-of-return percentage shall be employed that is representative of the utility's

[55] Direct Testimony of Ruth Gustin, 4:12-14.
[56] Petersen Rebuttal, 11:13-17.
[57] Glahn, 37:16-38:5.

weighted average cost of capital including, but not limited to, long-term debt, preferred stock, and common equity capital."[58]

"The Commission must allow each utility a reasonable opportunity to earn a reasonable rate of return, which is expressed as a percentage of invested capital, and must fix the rate of return in accordance with *Neb. Rev. Stat.* §§ 66-1825(3) and (5)."[59] In evaluating each case, the Commission "must consider the utility's cost of capital, which is the weighted average of the cost of the various classes of capital used by the utility".[60]

The classes of capital include debt and equity. "The cost of debt capital is the actual cost of debt."[61] "The cost of equity capital must be based upon a fair return on its value."[62]

Cost of Equity Capital

Both Aquila and the Public Advocate develop a set of comparable companies and use financial data for those companies, combined with the discounted cash flow (DCF) model and the capital asset pricing model (CAPM), to estimate a cost of equity capital for Aquila.

Aquila proposes a sample of eight comparable companies, in part because it excludes companies with capitalizations greater than $2 billion.[63] Aquila provided no explanation for the $2 billion cutoff. The Public Advocate proposes a sample of 12 comparable companies[64] that includes Aquila's eight comparable companies plus four other companies. All four of these additional companies have market capitalizations between $2.7 and $3.4 billion. The four companies in question are classified by *Value Line* as mid-cap natural gas distribution companies. Of the eight companies proposed by Aquila, seven are also listed as mid-cap natural gas distribution companies with capitalizations ranging from $1 to $2 billion. The Commission finds no justification for excluding the four companies from the group of comparable companies because of their market capitalizations.

Aquila argues that two of the four companies in question should also be excluded because of their product mixes. However, Aquila provides no data to show that either is

[58] § 66-1825(5).
[59] § 005.05A.
[60] § 005.05A2.
[61] § 005.05A2(a).
[62] § 005.05A2(b).
[63] Direct Testimony of Dr. Don Murry, 11:11-12 and 12:11-14.
[64] Glahn, 12:6-24; 13:10-17.

predominantly a non-regulated company. Both are included in *Value Line* as natural gas distributors. They should be included in the group of comparable companies.

Aquila generates DCF estimates in the range of 6.61 percent to 10.65 percent.[65] In developing these estimates, Aquila uses low and high stock prices for the past year and from a recent two-week period. Aquila also uses the 2006 dividend.[66] The Public Advocate develops DCF estimates in the range of 6.6 percent to 9.0 percent.[67] In developing these estimates, the Public Advocate uses the average of the monthly high and low stock prices over a recent three-month period and the 2007 expected dividend.[68]

The Public Advocate's approach for estimating the dividend yield is appropriate. The stock price information covers a period of time that is long enough to not be overly influenced by a very short-term stock. Yet it does not cover a time period so long as to no longer be relevant. In addition, using an average of the high and low stock prices washes out temporal variation that may exist in daily stock prices. In contrast, using only the high and the low stock prices over-emphasizes any temporal shocks in stock prices. The Public Advocate's use of an expected dividend is most appropriate for use in the DCF model as well. As a result, we conclude the most reasonable DCF estimates are in the range of 6.6 to 10.0 percent.

Both Aquila and the Public Advocate show concern for using equity cost estimates near the low end of the range. Given current market conditions, the Commission agrees and will focus on the upper estimate from the DCF model in determining the cost of Aquila's equity capital.

Aquila performs two CAPM analyses.[69] The first uses the current return on long-term government bonds as the risk free rate and the premium of common stock to long-term government bonds as the risk premium.[70] Aquila also applies a size premium adjustment to account for a purported bias in the CAPM that underestimates returns for small companies.[71] Aquila's second CAPM analysis uses the historical difference between the total market return and the long-term corporate bond return as the

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[65] See Aquila Exhibits DAM-17 - DAM-22.
[66] See Murry, 23.
[67] Glahn, 19:12-26.
[68] Glahn, 16:12-17.
[69] Murry, 33:14-17.
[70] Id.
[71] Murry, 33:17-20.

risk premium and uses the Aaa corporate bond rate as the risk free rate.[72]

The Public Advocate's CAPM analysis uses the current yield on 30-year U.S. Treasury bonds as the risk free rate and estimates the equity risk premium by subtracting the arithmetic mean of total returns on long-term government bonds from the arithmetic mean of total returns on large company stocks.[73]

Aquila's analysis that uses the historical return on corporate bonds as the risk free rate is a non-standard approach. Even high grade corporate bonds carry more risk than U.S. government bonds. One could reasonably expect any CAPM estimate using a corporate bond rate as the risk free rate to be higher than estimates using U.S. Treasury securities and Dr. Murry's results bear this out. This approach produces results that are clearly beyond the threshold of a reasonable range of allowable returns on equity in this matter.

Aquila's inclusion of a size adjustment in the CAPM model is unwarranted. The market factors that allow the universe of all small- and medium-cap privately held companies to over-perform their CAPM equity return predictions may or may not exist for the relatively small and unique set of regulated natural gas distribution companies. Until research becomes available establishing such a relationship, this size adjustment overstates the expected equity earnings for a regulated natural gas utility.

The record provides enough information to perform a CAPM analysis on the return on equity for the sample of 12 comparable companies using both Aquila's and the Public Advocate's preferred risk free rates and risk premia. The CAPM-generated returns on equity range between 10.4 and 11.26 percent, with the average of 10.8 percent.

Based on DCF and CAPM analysis, the Commission finds that a rate of return on equity capital of 10.4 percent is reasonable.

<u>Cost of Debt</u>

Aquila proposes a weighted average cost of long-term debt equal to 7.13 percent.[74] The Public Advocate takes exception with the re-pricing of the 11.875 percent series used to calculate that weighted average cost of debt, arguing that it

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72 Murry, 33:16-17.
73 Glahn, 20:12-21:8.
74 Murry, 15:1-2.

should be re-priced assuming an investment grade of BBB+.[75] This argument is unconvincing. Mr. Glahn's *Schedule 8* filed with his pre-filed direct testimony shows that four of the twelve companies in his comparison group have an S&P credit rating below BBB+. Two have a credit rating of BBB-. Southern Union, with an equity ratio of 50 percent has a BBB- rating. The Commission finds that a cost of debt equal to 7.13 percent should be used.

Capital Structure

Aquila proposes a capital structure of 51 percent equity and 49 percent debt.[76] The Public Advocate does not propose an alternate equity ratio. The Commission finds that an equity ratio of 51 percent is reasonable for Aquila Networks.

Overall Cost of Capital

The Commission concludes that Aquila Networks - Nebraska should be allowed a cost of equity equal to 10.4 percent, a cost of debt equal to 7.13 percent and a common equity ratio of 51 percent. This results in an overall cost of capital equal to 8.8 percent.

RATE MECHANISMS

Aquila has proposed three (3) automatic rate mechanisms: a weather normalization adjustment (WNA), a revenue normalization adjustment (RNA) and a limited cost recovery adjustment (LCR).

The WNA is an adjustment intended to account for variations in weather conditions so as to avoid spikes in utility revenue during colder periods and significant decreases in revenue during warmer weather.

"The RNA Rider is a billing adjustment factor computed on a monthly basis that creates a credit or charge to the monthly delivery charge for firm customers . . . designed to stabilize the level of revenues that are provided by customers to the Company each month."[77] In essence, the RNA is intended to address declining revenues related to decreases in declining usage.

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[75] Glahn, 28:3-29:2.
[76] Murry, 12:16-20.
[77] Direct Testimony of Paul Raab, 22:3-8.

The LCR is an adjustment for inflation which allows Aquila to increase rates based upon increases in the consumer price index.

Automatic rate mechanisms raise concerns of piecemeal rate making by adjusting for only one element of cost without accounting for other increases and decreases in costs incurred by the utility. Such automatic mechanisms can lead to excessive rates, an inappropriate shifting of risks from stockholders to ratepayers, and decreased incentives to operate efficiently. Therefore, their use should be limited.

Rate regulation under the State Natural Gas Regulation Act is relatively recent. Similarly, the move toward such automatic adjustments as proposed by Aquila is also fairly new. The Commission does not wish to dissuade utilities from seeking innovative approaches to rate making in Nebraska to ensure safe and affordable natural gas service for ratepayers. However, at this stage of natural gas rate regulation in Nebraska, the future impact of those mechanisms on ratepayers is difficult to ascertain. Therefore, the Commission finds that the rate mechanisms should be denied.

ENERGY EFFICIENCY RIDER

Aquila seeks a $0.0070 per therm surcharge listed as a separate line item on ratepayer's billing statements used to recover the costs of Aquila's energy efficiency and low income weatherization support program. The Public Advocate did not object to Aquila's proposal.

The Commission finds that the surcharge should be approved; however, we will require that Aquila true-up the actual amounts paid in the program and report the amounts attributable to the administrative program each six months.

RATE DESIGN

Traditional vs. Alternative Rate Design

Both Aquila[78] and the Public Advocate[79] recommend continuing the traditional rate design contained in current rates. A traditional rate design includes two components: (1) A fixed monthly charge, or customer charge, that does not vary with the level of usage, and (2) a commodity charge, or delivery charge,

[78] Direct Testimony of Thomas Sullivan, 20:1 - 24:6.
[79] Bartsch, 14:1 - 15:11.

per Therm that does vary with the level of usage. The sum of the customer charge and delivery charge are commonly referred to as the base rates. In addition to the base rates, a customer will be charged a Purchased Gas Cost Adjustment (PGA) charge for the cost of gas and other non-base rate charges such as franchise fees, regulatory assessments and taxes. The base rates are the charges that are to be determined in this proceeding.

Aquila's recommendation to continue using a traditional rate design is conditioned on the Commission also approving the Company's proposed RNA and WNA. In the alternative, Aquila is proposing two alternative rate designs.[80] Under rate design Alternative 1, Aquila would only increase the customer charge with the approved revenue increase. In other words, the Company would leave the commodity or delivery charges at current rate levels and use the entire amount of any approved revenue increase to increase the monthly customer charge. Under rate design Alternative 2, Aquila proposes to eliminate the commodity or delivery charge and recover all base rate revenues in the customer charge. This would result in a large, flat monthly charge for all customers in each customer class.

Aquila's rate design Alternative 1 has several problems that do not make it an acceptable rate design. First, as acknowledged by Aquila,[81] this alternative does not recognize the variance in costs to serve different sizes of customers that require varied capacity on the system. Under rate design Alternative 1, it is likely that large customers within a customer class will underpay their cost of service while small customers will overpay. In addition to this problem under rate design Alternative 1, small or low use customers will receive a significant percent rate increase while medium and large customers would pay less than current rate charges.[82] Because of these disparate customer impacts in each customer class, it would not be reasonable to adopt rate design Alternative 1, even if other factors supported its approval.

Aquila's rate design Alternative 2 has the same problems related to Alternative 1, only on a more magnified level.[83] In addition, the flat customer charge only rate design would decrease price incentives for customers to improve energy efficiency. The customer would pay the same base rate charge

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80 Sullivan, 25:1 - 31:20.
81 Sullivan, 30:11 - 14.
82 Aquila's Exhibit TJS-9 and Exhibit TJS-10.
83 Sullivan, 31:3-7, Aquila's Exhibit TJS-9 and Exhibit TJS-10

regardless of how much the customer can reduce its energy needs through energy conservation.

For the reasons discussed, the approved rates should be based upon a traditional rate design. Accordingly, Aquila's proposed rate design Alternatives 1 and 2 should be rejected.

Consolidated Rate Area Rates

In the past, Aquila has had separate base rates for Rate Areas 1, 2 and 3. The three rate areas were established under the prior regulatory structure whereas the municipals within each rate area regulated the natural gas rates. In this case, Aquila is proposing to consolidate the rates in each rate area into a Nebraska-wide or consolidated rate.[84] The primary reason for consolidating the different rate area rates is that the cost of service and current rates of each rate area are not that different. The Public Advocate concurs that rate areas should be consolidated.[85]

The reasons submitted by Aquila support consolidating the rates in each rate area into a Nebraska-wide rate. In addition, a consolidated rate will reduce administrative and regulatory expenses. The Company's proposal to consolidate the rate area rates into on Nebraska-wide rate is approved.

Customer Charge Level

Under the traditional rate design, Aquila is proposing to significantly increase the fixed monthly customer charge for both the residential and commercial customer classes. As explained by Aquila witness Thomas Sullivan, the large increases are intended to recover more of the fixed customer-related costs in the customer charge rather than in the volume-related or variable commodity charge (delivery charge).[86] The table below summarizes Aquila's proposal regarding customer charges:[87]

Customer Class	Current Customer Charges	Proposed Customer Charges	Aquila Proposed Monthly Increase	
			Amount	Percent
Residential	$11.00	$16.00	$5.00	45.5%
Commerical	$15.00	$20.00	$5.00	33.3%

[84] Sullivan, 22:3 - 13.
[85] Bartsch, 11:1-21.
[86] Sullivan, 21:10 - 22:2.
[87] Aquila's Exhibit TJS-7.

The Public Advocate disagrees with Aquila on the amount of costs classified as customer-related. While the Public Advocate believes that the customer charge should increase by a greater percent than the commodity or delivery charge,[88] the Public Advocate is recommending a much smaller increase in the monthly customer charges.

The record supports an increase in the monthly customer charges, however, the level of Aquila's recommended increase is too large. Additionally, Aquila's proposed shift of additional costs is based upon a rate design established during the utility's last rate case. The outcome of that case was a generic or "black box" settlement. Although the Commission found the rates in the prior case to be just and reasonable, the issue of rate design was not litigated.

The Commission recognizes the benefits of sending proper price signals to ratepayers in order to encourage conservation. We also recognize that nationally some states have chosen to move a greater portion of fixed costs from the volumetric charge to the fixed charge. Utilities have argued that such reallocation of costs between the fixed and volumetric charges will eliminate the utility's disincentive to encourage conservation.

Additionally, proper price signals are necessary to encourage efficiency in the provision of natural gas service. In determining fair and reasonable rates, the Commission must strike the appropriate balance between ensuring that the utility has a reasonable opportunity to earn a fair rate of return and protecting ratepayers from unreasonable impacts of dramatic increases in fixed rates. We are not convinced that a substantial increase in the customer charge strikes that balance.

Therefore, the Commission finds that the approved customer charges are $12.00 per month for the residential class and $17.00 per month for the commercial class. The balance on the revenues assigned to each customer class should be recovered in the commodity or delivery charge resulting in a rate of $0.15406 for residential customers and $0.17561 for commercial customers. The Commission will continue to be open to innovations in rate design that are in the best interest of ratepayers.

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[88] Bartsch, 14:21 - 23.

ALLOCATED COST OF SERVICE

The allocated cost of serving each customer class is usually the primary factor to consider in setting revenue levels by customer class. Other factors may be considered as well which could result in customer class revenue levels above or below the class' allocated cost of service.[89] The customer class allocated cost of service study is also used to allocate cost between Aquila's unregulated or large volume customers and the regulated (residential and commercial) customers.

Cost of service studies can be developed using a variety of methodologies and require some subjectivity by the ratemaker. Since the cost of service study is the primary consideration in determining customer class revenue levels and rate levels, it is important that the cost of service study be as accurate as possible. Aquila witness Thomas Sullivan presented the Company's proposed cost of service study. Albert Bartsch and Kimberly Lillyblad presented a differing view of the appropriate class allocated cost of service study on behalf of the Public Advocate.

Direct Assignments to Large Volume Customers

Rates and service rules for Aquila's large volume or industrial customers continue to be unregulated, i.e., similar to the regulatory structure when municipals regulated rates in each rate area. While the Commission does not set rates for Aquila's large volume customers, the Commission can determine the appropriate allocation of costs to the large volume customer class. This allocation of costs between Aquila's large volume customer and all other customers is the jurisdictional allocation that determines the level of rates from the customer classes that the Commission does have jurisdiction over.

A major issue in determining this jurisdictional allocation, or split, was the direct assignment of the cost of mains to certain large volume customers and to the existing rate areas. Aquila argued that it has traditionally directly assigned the costs of specific mains used to serve specific rate areas and industrial customers to those areas and customers. In addition, those industrial customers receiving service from directly assigned mains were not further allocated the costs of mains used to provide services to all other customers.

The Public Advocate stated that no mains should be directly assigned. Instead the cost of all mains should be allocated to

[89] Bartsch, 14:3 - 23.

the customer classes based on allocation factors.[90] Mr. Bartsch claims that allocating all costs, instead of directly assigning costs specifically used to serve certain rate areas and customers, is both "much simpler" and also more accurate.[91] In addition, the Public Advocate witness claims to have based the Public Advocate's cost allocation study using the criteria established in NARUC's Gas Distribution Rate Design Manual.[92]

The primary difference between the utility and the Public Advocate is the allocation of transmission mains (Account No. 367) and of distribution mains (Account No. 376). Aquila directly assigns the cost of mains to specific rate areas or customers, or groups of customers, when the data is available, and then allocates the remaining cost of mains to all other customers. The Public Advocate does not directly assign any costs and allocates all costs based on allocation factors.

In general, the Commission believes that the direct assignment of costs to customers or customer classes will result in a more accurate cost of service study if adequate accounting information is available to support the direct assignments. Despite the Public Advocate's claim that it based their cost of service study on the principles included in the NARUC Gas Distribution Rate Design Manual, the Public Advocate did not seem to follow this manual with regard to direct assignments. On page 20 of that NARUC manual, the guidance on direct assignments is as follows:

> All items that can be directly attributed to a particular service (such as revenues from a specific service or the cost of a high pressure main constructed for a particular customer or group of customers) should be segregated and directly assigned to the appropriate customers.

Accordingly, in this proceeding, the Commission accepts Aquila's direct assignment and allocation of mains. However, the Commission believes this is a significant issue that did not receive adequate attention in this case. We, therefore, direct the parties to further develop and analyze the benefits and risks of this issue in Aquila's future rate case. In addition, Aquila should address in its next rate case filing the reasons that a consolidated (Rate Area 1 though 4) cost of service study is not preferable to its Rate Area specific cost allocation methodology.

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[90] Bartsch, 10:16.
[91] Bartsch, 11:10 - 21.
[92] Bartsch, 10:12 - 13.

Account Nos. 381 through 385 Weighting Factors

The other major cost allocation issue is the appropriate weighting factors to be used in developing allocation factors for use in allocating plant costs booked to Account Nos. 381 through 385. As listed in the FERC Uniform System of Accounts, these accounts are identified as follows:[93]

Account Number	Description
Account No. 381	Meters
Account No. 382	Meter Installations
Account No. 383	House Regulators
Account No. 384	House Regulator Installations
Account No. 385	Industrial Measuring & Regulating Station Equipment

Weighting factors are applied to the number of customers in each customer class to reflect the difference in costs per customer for the equipment costs. For example, meters for residential customers cost less than meters for large commercial customers. Accordingly, commercial customers have a higher weighting factor when developing the allocation factor for meter related costs.

Aquila presented a Weighting Factor Study that the Company had prepared in support of its proposed weighting factors.[94] Aquila used its plant accounting data to develop the weighting factors. The Public Advocate accepted Aquila's weighting factors for Account Nos. 381 through 384 but directly assigned all of Account No. 385 costs to the large volume or unregulated customers. Ms. Lillyblad explained in her direct testimony that she directly assigned Account No. 385 costs to the large volume customers based upon the FERC definition of costs to be included in Account No. 385.[95] On rebuttal, Mr. Sullivan explained that metering and regulating equipment costs booked to Account No. 385 serve both large regulated and unregulated customers.[96]

The analysis and information provided supports adoption of Aquila's allocation of costs in Account Nos. 381 through 385 and of Aquila's weighting factors.

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[93] Rebuttal Testimony of Thomas Sullivan, 24:4 - 16.
[94] Aquila Rebuttal Testimony Exhibit TJS-6.
[95] Direct Testimony of Kimberly Lillyblad
[96] Sullivan Rebuttal, 26:14 - 31:22.

Other Cost Allocation Issues

The two most significant cost allocation issues are those previously discussed and decided. In Aquila's Post Hearing Brief, several other differences in allocations between the utility's and the Public Advocate's cost of service studies are listed.[97] These other cost allocation issues include:

1. Application of correct weighting factors to Account No. 380,
2. Allocate Account No. 387 based on the customer accounts weighting factor,
3. Allocate Account No. 874 based on the combined mains and services plant accounts,
4. Allocate Account No. 892 based on the services plant account,
5. Exclude the acquisition adjustment balance from the determination of net plant, and
6. Allocate depreciation reserves and depreciation expenses for the acquisition adjustment on the corrected net plant allocator rather than on general plant.

In the rebuttal testimony of Thomas Sullivan, these other cost allocation issues are discussed.[98] There is not any specific support in the Public Advocate's direct testimony for these other cost allocation issues. At the hearing, Mr. Bartsch agrees with using the Aquila's weighting factors for Account No. 380.[99] For the remaining other cost allocation issues, the only evidence in the record on these issues supports Aquila's position. For purposes of this proceeding, therefore, the Commission accepts the Company's methodology on these other cost allocation issues.

Jurisdictional Cost Separation

As previously mentioned, the allocated cost of service study is used for both allocations to jurisdictions and to customer classes. Since the Commission has not changed Aquila's allocation methodologies for purposes of jurisdictional allocations, Aquila's assignment of costs to the Nebraska regulated jurisdiction prior to any jurisdictional revenue requirement adjustments is approved. However, we do agree with the Public Advocate that the allocation model used by Aquila to determine the jurisdictional allocations and test year adjustments can be improved. In the next Aquila rate case, we

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97 Post Hearing Brief of Aquila, at 108.
98 See Sullivan Rebuttal.
99 Tr., 239:15 - 240:2.

order that the rate filing schedules used to determine the utility's revenue requirement include both total Nebraska amounts and the Commission's jurisdictional amount. Any test year adjustment should also be made to the total Nebraska amounts as well as to the jurisdictional amounts.

Revenue Distribution

While the allocated cost of service study is the primary factor to be considered in distributing the proposed revenue increase among the customer classes, other factors should also be considered.[100] As explained by Mr. Bartsch, some of these other factors include: rate stability, customer impacts, energy efficiency incentives, ease of understanding, and gradualism.[101] In order to temper the rate impacts on certain customers or customer classes, it is common to gradually move to cost-based rates rather than move completely in one rate case. This concept or factor is commonly referred to as gradualism. Gradualism is also supported by the NARUC Gas Distribution Rate Design Manual.

Aquila has not applied gradualism and instead is proposing to set customer class revenue levels equal to their allocated cost of service. The result is widely varying rate increase levels as shown on Aquila's rate filing Exhibit TJS-9, page 2, column (x). As shown on this exhibit, the cost-based rates would result in substantial percent increases in base rates for residential customers while the commercial and Energy Options customers would receive substantial rate reductions. This outcome is inappropriate.

The Public Advocate's recommended gradualism constraint is to limit the percent increase to the residential class to 1% above the total average percent increase for all customers.[102] We accept the PA's gradualism recommendation. Based upon the Commission's approved total revenue increase, this would result in the following rate increases for each of the customer classes:

[100] Bartsch, 13:1 - 14:23.
[101] Id.
[102] Direct Testimony of Albert Bartsch, 14:15 - 23.

Customer Class	Current Rate Revenues	Approved Rate Revenues	Approved Increase
Residential	$37,101,291	$44,175,730	$7,074,439
Commercial	$9,506,174	$10,961,992	$1,455,818
Energy Options	$4,066,825	$4,691,351	624,525
Total	$50,674,291	$59,829,072	9,154,782

COMPLIANCE

The Commission finds that a compliance conference should be scheduled by the hearing officer to allow all parties an opportunity to discuss the terms and practical effects of the order. Subsequent to the conference, Aquila shall submit to the Commission a Compliance Filing which shall include at least the following information.

Interim Rate Refund Plan

As permitted by law, Aquila implemented interim rates pending the consideration of its rate application.[103] Aquila chose to implement the full amount of its proposed rate. As a result of the Commission's decision herein, ratepayers are entitled to a refund of any amounts paid over and above the rates approved herein.

The Commission recognizes that companies may implement interim rates in a variety of appropriate ways. The method for calculating refunds must be consistent with the manner in which the interim rate was implemented. Aquila will be required to file a Refund Plan within 30 days from the compliance conference referenced herein. That Refund Plan will include a proposal for refunding the differences between the interim rate revenue collected and its final rates. The Commission reserves the ability to receive evidence regarding such Refund Plan and to enter a subsequent order regarding such Refund Plan as hereafter provided in this order.

Energy Efficiency Rider

Consistent with the terms herein, Aquila shall file with the Commission information each six months regarding the amount

[103] "If the rate filing is not certified by the commission for negotiations, the jurisdictional utility's filed rates may be placed into effect as interim rates, subject to refund, upon the adoption of final rates, ninety days after filing with the commission." *Neb. Rev. Stat.* § 66-1838(10)(b) (2003).

of rebates given and low-income weatherization provided as well as the administrative costs for the programs.

Tariff Sheets

Finally, within thirty (30) days of the compliance conference, Aquila shall file any necessary tariff sheets with the Commission.

O R D E R

IT IS THEREFORE ORDERED by the Nebraska Public Service Commission that Aquila's application is approved in part and denied in part as set forth specifically herein.

IT IS FURTHER ORDERED that Aquila has a revenue requirement of $59,829,072.00, representing an increase of $9,154,782.00.

IT IS FINALLY ORDERED that Aquila shall make a compliance filing consistent with the findings herein within thirty days of the compliance conference to be scheduled by the hearing officer.

MADE AND ENTERED at Lincoln, Nebraska this 24th day of July, 2007.

NEBRASKA PUBLIC SERVICE COMMISSION

COMMISSIONERS CONCURRING:

Gerald L. Vap

Frank Landis

Tim Schram

Chairman

ATTEST:

Executive Director

COMMISSIONERS DISSENTING:

//s// Rod Johnson